

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS: [REDACTED]:POSTF-133725-02
[REDACTED]

date: April 11, 2002

to: Territory Manager (Manufacturing & Transportation)
Attention: Group [REDACTED]-LMSB

from: Associate Area Counsel
CC:LM:FS: [REDACTED]

subject: [REDACTED]

EIN: [REDACTED]
Taxable years [REDACTED] & [REDACTED]
U.I.L. No. 0451.15-00

Reference is made to our memorandum dated March 20, 2002, in response to your request for advice concerning the taxpayer's deferral of income from its sales of [REDACTED]. We stated in the memorandum that it was being referred to the National Office for review, that the review might result in modifications to the advice rendered therein, and that we would inform you of the results of the review.

The memorandum was reviewed by subject matter specialists in the National Office. We were notified that while the National Office concurs with our legal analysis regarding the taxpayer's arguments under I.R.C. § 451(f) and Prop. Treas. Reg. § 1.863-9, the subject matter specialist believes that the taxpayer may be eligible for deferral under Rev. Proc. 71-21, 1971-2 C.B. 549.

Rev. Proc. 71-21 implements an administrative decision made by the Commissioner in the exercise of the Commissioner's discretion under I.R.C. § 446 to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for federal income tax purposes of advance payments for services. Specifically, Rev. Proc. 71-21 provides that a taxpayer on the accrual method of accounting who receives advance payments for services to be provided before the end of the next succeeding tax year may defer the inclusion of income over the time in which the services are provided, rather than including the entire amount in income upon receipt. The

National Office informed us that the Service has allowed other taxpayers to defer income where the services are performed by a third-party as long as the taxpayer is obligated to provide the services. In addition, the Service has not interpreted the revenue procedure in such a narrow way as requiring the taxpayer to receive the funds from the ultimate user of the service. It is our understanding that all of the taxpayer's [REDACTED] [REDACTED] have expiration dates. Therefore, the taxpayer would be eligible to defer recognition of such income provided that (1) the taxpayer is required to provide the [REDACTED] to the [REDACTED] holder before the end of the year succeeding the year in which the cards are sold to the distributors and (2) the [REDACTED] [REDACTED] expire within that time frame.

This memorandum modifies the preliminary conclusion and the Rev. Proc. 71-21 legal analysis contained in our original memorandum. Based on the supplemental guidance provided by the National Office, we conclude that the taxpayer may be allowed to defer income from the sales of [REDACTED] consistent with the provisions of Rev. Proc. 71-21. If you have any questions or require further assistance, please contact [REDACTED] [REDACTED] at [REDACTED].

[REDACTED]
Area Counsel (Financial Services)

By: _____
[REDACTED]
Associate Area Counsel

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS: [REDACTED]:POSTF-133725-02
[REDACTED]

date: March 20, 2002

to: Territory Manager (Manufacturing & Transportation)
Attention: Group [REDACTED]-LMSB

from: Associate Area Counsel
CC:LM:FS: [REDACTED]

subject: [REDACTED]

EIN: [REDACTED]

Taxable years [REDACTED] & [REDACTED]

U.I.L. No. 0451.15-00

This memorandum responds to a March 11, 2001 request for assistance from [REDACTED] of your staff concerning the taxpayer's deferral of income from its sales of [REDACTED]. This memorandum should not be cited as precedent.

FACTS

The relevant facts, as we understand them, are as follows:
[REDACTED], an accrual basis taxpayer, is a [REDACTED] based marketer of [REDACTED]. The taxpayer sells its [REDACTED] to wholesale distributors. The sale terms range from cash on delivery to payment within thirty days of delivery. All sales are final and the distributors have no contractual right to return [REDACTED] to the taxpayer. These independent distributors sell the [REDACTED] to sub-distributors who in turn sell the [REDACTED] to retail outlets for resale to the public. The [REDACTED] is typically available in \$ [REDACTED] and is usually sold at [REDACTED]. [REDACTED] has no business dealings with either the sub-distributors or the retailers. The taxpayer, however, does maintain a customer service operation to handle inquiries from end users relating to its [REDACTED]. [REDACTED] purchases [REDACTED] from unrelated third-party [REDACTED]. The

[REDACTED]

For tax purposes, the taxpayer defers the recognition of revenue from the sale of the [REDACTED] to the distributors until the [REDACTED] utilizes the [REDACTED]. The taxpayer contends that since the company leases [REDACTED] it is a [REDACTED] service within the meaning of I.R.C. § 451(f) and may defer recognition of income until the [REDACTED]. The taxpayer asserts that Prop. Treas. Reg. § 1.863-9 further supports its position that the company is a [REDACTED] service rather than a wholesaler of [REDACTED] as originally reported on their tax returns. Furthermore, the taxpayer states that Rev. Proc. 71-21, 1971-2 C.B. 549 provides additional authority for deferral treatment. The revenue agent believes that the payments received from the distributors upon the sale of the [REDACTED] should be included in the gross income of the taxpayer in the tax year the payments are received.

ISSUE

Whether, under the facts presented, the taxpayer may defer recognition of income from payments received upon the [REDACTED] to distributors until the actual [REDACTED] are used by the [REDACTED] holder?

LEGAL ANALYSIS

I.R.C. § 61(a) requires all income from whatever source derived to be included in gross income. I.R.C. § 451(a) requires the amount of any item of gross income to be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. I.R.C. § 446(c) allows a taxpayer to compute taxable income under an accrual method of accounting, subject to certain limitations. Treas. Reg. § 1.451-1(a) provides, in part, that under an accrual method of accounting, income is includible in gross income when all the events have

occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. All the events that fix the right to receive income occur when (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever happens first. See Schlude v. Commissioner, 372 U.S. 128 (1963); Union Mutual Life Insurance Co. v. United States, 570 F.2d 382, 385 (1st Cir. 1978); Automobile Club of New York, Inc. v. Commissioner, 32 T.C. 906, 911-913 (1959), aff'd, 304 F.2d 781 (2d Cir. 1962). In the present case, the "all events test" is satisfied upon payment by the distributor. Ownership and possession of the prepaid cards is transferred from the taxpayer to distributor. At the time of payment, the sales transaction is completed and taxpayer has unrestricted use of the funds. Therefore, the payments are properly included in gross income when received.

The taxpayer asserts that I.R.C. § 451(f) provides the requisite statutory authority for deferral. I.R.C. § 451(f) provides that, in the case of accrual method utility companies, any income attributable to the sale or furnishing of utility services to customers is includible in gross income no later than the taxable year in which the customer uses the service. I.R.C. § 451(f)(2)(A)(iii) defines utility services to include telephone or other communications services. Although the taxpayer may lease switching equipment, it does not provide telephone services.

[REDACTED]

^{1/} The taxpayer's contention that Treas. Reg. § 1.863-9

^{1/} We further note that all reported cases dealing with I.R.C. § 451(f) involve public utility companies providing gas, electricity and related services. Prior to the enactment of I.R.C. § 451(f), these utilities recognized taxable income from services based on the taxable year in which its customers' utility meters were read, i.e. the cycle meter-reading method. Under this method, utility services provided to customers during the unbilled period were not recognized as income until the following taxable year. I.R.C. § 451(f) effectively requires utilities to discontinue using the cycle meter-reading method of accounting and adopt a method of accounting that included taxable income from utility services provided during the taxable year, including any unbilled period. See also Senate Committee Report, P.L. 99-514.

buttresses its I.R.C. § 451(f) utility service argument is without merit. The provisions of I.R.C. § 863 and regulations promulgated thereunder provide special rules for the proper sourcing of income items only. Moreover, Prop. Treas. Reg. § 1.863-9 specifically addresses only the sourcing of income derived from transmitting communications between the United States and a foreign country. These sourcing rules are not relevant for purposes of determining whether the taxpayer is a utility service within the meaning of I.R.C. § 451(f).

The taxpayer's attempt to rely on Rev. Proc. 71-21 is equally unpersuasive. Rev. Proc. 71-21 implements an administrative decision made by the Commissioner in the exercise of the Commissioner's discretion under I.R.C. § 446 to allow accrual method taxpayers in certain specified and limited circumstances (emphasis added) to defer the inclusion in gross income for federal income tax purposes of advance payments for services. Specifically, Rev. Proc. 71-21 provides that a taxpayer on the accrual method of accounting who receives advance payments for services to be provided before the end of the next succeeding tax year may defer the inclusion of income over the time in which the services are provided, rather than including the entire amount in income upon receipt. While we concede that Rev. Proc. 71-21 does not define the term "services", we believe that a literal reading of the revenue procedure precludes income deferral. First, Rev. Proc. 71-21 by its terms applies only to contracts for the performance of services. Here, the taxpayer provides no services to the distributor under the terms of sale. The transaction between the parties is more appropriately characterized as a sale of property rather than payment for services. Second, the taxpayer does not squarely fit within any of the examples contained in Rev. Proc. 71-21. Therefore, we conclude the taxpayer is not entitled to rely upon Rev. Proc. 71-21 to defer income recognition because the income derived from the sale of the [REDACTED] to the distributors does not represent payment for services.

CONCLUSION

Based on the above, all payments received by the taxpayer upon the sale of the [REDACTED] are included in the

Therefore, even assuming *arguendo*, that the taxpayer is a utility, its purported reliance on I.R.C. § 451(f) seems misplaced because the provision only applies to a specific timing issue that has no application to the relevant facts of this case.

gross income of the taxpayer in the tax year the payments are received.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures, which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions or require further assistance, please contact [REDACTED] at [REDACTED].

[REDACTED]
Area Counsel (Financial Services)

By: _____

[REDACTED]
Associate Area Counsel